

The leasing of its adjacent office building, and the furnishing of certain office services, by an exempt hospital to a hospital-based medical group is not unrelated trade or business under section 513 of the Code.

A community hospital exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 has asked whether the leasing arrangements described below constitute unrelated trade or business under section 513 of the Code.

The hospital has a medical staff of over 150 physicians and surgeons who have the privilege of admitting and treating patients in the hospital. However, in order to improve the hospital's ability to deliver a full range of health services to the community, the board of trustees decided to enter into negotiations with a medical group to induce them to carry on their professional activities on the hospital premises.

The medical group consists of 25 physicians and surgeons who, as their principal professional activity and as a group responsibility, are engaged in the coordinated practice of medicine in a common facility. The group is composed of a variety of medical specialists, including radiologists, pathologists, anesthesiologists, and internists.

As a result of arm's length negotiations, the hospital leased its adjacent office building to the group. The group uses the facility to provide medical services for its private patients. In addition, under the terms of the contract the various specialists within the group are also responsible for providing all diagnostic and therapeutic procedures, such as anesthesiology and radiology, to all hospital patients. The contract also requires that the group operate the hospital's emergency room on a 24-hour basis.

Because of its physical proximity to the hospital, the group is able to serve the outpatient needs of persons seeking medical services from the hospital on an ambulatory basis. In this way, the medical group also functions as the outpatient department of the hospital. The hospital maintains all medical records of the group as part of its central record keeping system.

Under the terms of the contract, the hospital provides the group with the nursing, secretarial, billing, collection, and record keeping services needed to carry on its medical practice.

In consideration for the office space and services provided, the group is required to pay the hospital a fixed percentage of its gross billings for services rendered to both hospital and private patients.

The hospital has established that the presence of the group practice at the hospital has had the effect of (1) reducing

hospital admissions, days of stay, and surgical rates; (2) permitting more efficient use of existing facilities; (3) making more effective use of scarce health manpower; (4) fulfilling the hospital's role as the health center of the community; (5) fixing administrative responsibility in a single group; and (6) making more effective use of hospital facilities for training purposes.

Section 513 of the Code defines the term 'unrelated trade or business' as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is 'substantially related' to exempt purposes when the business activity has a substantial causal relationship to the achievement of the exempt purposes.

Section 1.514(b)-1(c)(1) of the regulations indicates, by example, that where a tax-exempt hospital leases real property owned by it to an association of doctors for use as a clinic, the rents derived under such lease would not be included in computing unrelated business taxable income if the clinic is substantially related to the carrying on of hospital functions.

A lease by a hospital of part of the hospital to a doctors' association to use as a clinic is generally considered a trade or business related to the carrying on of hospital functions. See S. Rep. No. 2375, 81st Cong., 2nd Sess., C.B. 1950-2, 483 at 507. One definition of the term 'clinic' is 'a group practice in which several physicians work cooperatively.' (Webster's Seventh New Collegiate Dictionary, 1967.) It is held that the group practice described above contributes importantly to the hospital's operations and is therefore substantially related to the carrying on of hospital functions. Accordingly, the leasing activity described above is not unrelated trade or business under section 513 of the Code.